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Attorneys for Debtor

IN THE UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF OREGON

In re

Carolina Tobacco Company,  
Debtor.

Case No. 05-34156-elp11

CAROLINA TOBACCO COMPANY'S  
RESPONSE TO EMERGENCY  
MOTION OF SETTLING STATES TO  
ENFORCE DEBTOR'S THIRD  
AMENDED PLAN OF  
REORGANIZATION DATED  
OCTOBER 18, 2005 (AS MODIFIED  
FEBRUARY 24, 2006)

Carolina Tobacco Company, the reorganized Debtor in the above-captioned bankruptcy proceeding ("CTC"), hereby responds to the Settling States' Emergency Motion to Enforce Debtor's Third Amended Plan Dated October 18, 2005 (as Modified February 24, 2006) (the "Motion"). While CTC is willing to segregate additional funds for the ultimate payment of escrow deposits for 2006 sales, CTC has not violated the Plan and the Settling States' Motion should be denied.

**Background Facts**

The Plan requires that the Debtor "segregate the amounts necessary to pay all NPM escrow obligations by the 15th day of each month for the previous month's sales." (Plan,

Article 6.09(h)). This Plan requirement is one that is not imposed upon non-participating manufacturers (“NPM’s”) under state law. Rather, state law requires NPMs to make deposits for the previous calendar year’s sales by April 15<sup>th</sup> of the following year. An NPM is not required to segregate sums that will ultimately be required for such deposits on a monthly basis.

Escrow deposits are calculated by using the following formula: *number of cigarettes sold during period x NPM Base Rate x Inflation Adjustment Rate*. (Jennifer Li Declaration ¶ 2). The schedule of NPM Base Rates is set forth in Exhibit T of the MSA (the model escrow statute, which all of the relevant states have adopted). *Id.* The NPM Base Rate varies from year to year but is set forth in the model escrow statute. *Id.*

However, the Inflation Adjustment Rate is unknown during the year in which the sales are generated. *Id.* at ¶ 3. Price Waterhouse Coopers (“PWC”) is the independent auditor for the MSA. *Id.* PWC sets the inflation adjustment in approximately March or early April each year for the previous sales year. *Id.* Throughout the sales year, parties can only speculate as to what the Inflation Adjustment Rate will ultimately be because PWC does not determine the actual Inflation Adjustment Rate until months after that calendar year is over. *Id.*

The product of the NPM Base Rate and the Inflation Adjustment Rate equals the accrual rate that CTC uses to calculate the escrow deposits due for a given sales year (the “NPM Fee Rate”). *Id.* at ¶ 4. When the Plan was formulated, including the projections attached to the Plan as Exhibit 3, CTC had to estimate what the Inflation Adjustment Rate would be to calculate the NPM Fee Rate for escrow deposits. *Id.* Those rates were simply that, estimates.

At the time the Plan was formulated and confirmed, the Inflation Adjustment Rate had not yet been set by PWC for the 2005 sales year. *Id.* at ¶ 5. Ultimately, PWC, post-confirmation, determined that the actual 2005 Inflation Adjustment Rate was 1.2425497. The NPM Base Rate for 2005 was \$0.0167539 per cigarette. *Id.* The product of the two is \$0.02081755. *Id.* Accordingly, while CTC had estimated in the projections that the NPM Fee Rate per cigarette sold was going to be \$0.0212 for the sales year 2005 the actual rate was

1 \$0.02081755, a lower NPM Fee Rate per cigarette than CTC had projected. *Id.*

2 Historically and consistent with the MSA and Qualifying Statute, CTC has not  
 3 had to segregate amounts monthly for escrow deposits to be made in the following year. *Id.* at ¶  
 4 6. However, CTC has had to make quarterly escrow deposits to fifteen states that require  
 5 deposits be made quarterly in a given sales year. *Id.* With the quarterly states, and depending on  
 6 the state at issue, escrow deposits and certifications are due between fifteen days to forty-five  
 7 days after the end of the quarter. *Id.* CTC sends a letter to each quarterly state requesting that the  
 8 quarterly state provide the total number of CTC cigarettes reported as sold during the previous  
 9 quarter. *Id.* "Sales" are typically the number of cigarettes that have been stamped with the state's  
 10 tax stamp for sale in that state. *Id.* This information comes from distributor's and stamping  
 11 agent's reports to the states regarding the total number of tax stamps applied to cigarette packs  
 12 during a quarter. *Id.* Responses from the quarterly states are varied. *Id.* Some states provide the  
 13 information, while often times, others do not have complete information when the escrow  
 14 deposits are due for that quarter. *Id.* In those cases, CTC makes a best determination for that  
 15 state's quarterly escrow deposit. *Id.* Once the quarterly state has the final figure, it will inform  
 16 CTC of the total number of cigarettes and whether CTC over or under deposited for the quarter.  
 17 *Id.* Under deposits are made up promptly after notification from the state, and over deposits are  
 18 applied to the next quarterly deposit. *Id.*

19 The majority of the fifteen states that require quarterly deposits have compliance  
 20 certification forms that CTC completes whenever a quarterly escrow deposit is due. *Id.* at ¶ 7.  
 21 Forms and procedures are not standardized state by state, though some states may use a similar  
 22 form. *Id.* The compliance form used by some states listed an estimated \$0.02144 rate for 2006  
 23 sales on their compliance forms. *Id.* CTC used this rate to calculate its quarterly escrow deposits  
 24 for all states, except as set forth below for the states of California (for first quarter) and  
 25 Washington. *Id.*

26 California's compliance form simply states that the escrow deposit must be

adjusted for inflation, but does not specifically list a figure to use for inflation. *Id.* at ¶8. In a letter dated August 24, 2006, California confirmed that it would use the estimated \$0.02144 rate for its quarterly 2006 escrow deposits. *Id.* In that letter, California requested that CTC deposit an additional approximately \$5,000 for the Inflation Adjustment Rate for the first quarter. *Id.* CTC complied with that request. *Id.* Washington does not require quarterly escrow deposits to reflect an inflation adjustment and instead expects that the inflation adjustment be deposited with CTC's escrow deposits in April, 2007 for 2006 sales. *Id.*

From CTC's experience in dealing with the quarterly states, many quarterly states seem to view the quarterly escrow deposits as a good faith effort to comply with the law. *Id.* at ¶ 9. Sales figures are often inaccurate or incomplete, on either the state or the manufacturer's side. *Id.* Many states realize this and are amenable to the manufacturer making up the difference after the quarterly deposits have been made or even in the following April 15 deposit. *Id.*

Given that CTC has never segregated monthly deposits for the states that require payment only after the sale year at issue, prior to being required to do so during the bankruptcy, CTC used the NPM Base Rate for 2005 and 2006 of \$0.0167539 per cigarette and the NPM Fee Rate of \$0.02081755 (based on the 2005 Inflation Adjustment Rate). *Id.* at ¶ 10. In approximately September 2006, CTC hired Edward Hostman, Inc. ("EHI") to carry out financial analyses. *Id.* Based upon EHI's work, CTC adjusted the NPM Fee Rate for its monthly deposits into the segregated accounts to \$0.02144 which is the rate given to CTC by the quarterly states as referenced above. *Id.*

#### **Relief Requested by States Should be Denied**

The Settling States point to Article 6.09(a) of the Plan as requiring that the Debtor must segregate monthly using an NPM Fee Rate listed on page 19 of Exhibit 3 to the Plan. However, Exhibit 3 to the Plan prepared by EHI was a set of **projections**. As proven by the PWC Inflation Adjustment Rate established by 2005, the NPM Fee Rate per cigarette sold for the year 2005 projected by EHI was high. Article 6.09(a) of the Plan simply requires that the

1 “Debtor shall make every reasonable effort to operate and expend funds in accordance with the  
2 projections in Exhibit 3.” It does not require the Debtor to use NPM Fee Rates that are inflated  
3 or that are different from those estimates made by the States themselves.

4 What the Settling States request is that the Court require the Debtor to use an  
5 NPM Fee Rate that is likely inflated and is different from and higher than the rate that the States  
6 themselves estimate will ultimately be established by PWC. That is not “reasonable.” As a  
7 result, CTC’s segregation of monthly deposits at the NPM Fee Rate estimated by the quarterly  
8 states is appropriate and is in compliance with the Plan.

9 CTC is willing to segregate additional amounts necessary to make up the  
10 difference between the fees segregated using the 2005 NPM Fee Rate (\$0.02081755) and the  
11 2006 NPM Fee Rate estimated by the States (\$0.02144) for the time period prior to September  
12 2006. In fact, CTC has projected such a make-up payment in January of 2007, which totals  
13 \$267,497.04.<sup>1</sup>

14 Dated: January 5, 2007.

15  
16 FARLEIGH WITT

17  
18 By: /s/ Tara J. Schleicher  
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22 Of Attorneys for Debtor Carolina Tobacco  
23 Company  
24

25 <sup>1</sup> This amount is composed of \$202,405.20 (the cases sold as previously reported to the States  
26 times the NPM Fee Rate given to CTC by the States of \$0.02144) plus \$65,091.84 for deposits  
on 253 cases erroneously omitted from the previous report, but disclosed to the States in  
response to Interrogatories in Adversary Proceeding No. 06-3336-elp.

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Attorneys for Debtor

IN THE UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF OREGON

In re

Carolina Tobacco Company,  
Debtor.

Case No. 05-34156-elp11

DECLARATION OF JENNIFER LI IN  
SUPPORT OF CAROLINA TOBACCO  
COMPANY'S RESPONSE TO  
EMERGENCY MOTION OF SETTLING  
STATES TO ENFORCE DEBTOR'S  
THIRD AMENDED PLAN OF  
REORGANIZATION DATED  
OCTOBER 18, 2005 (AS MODIFIED  
FEBRUARY 24, 2006)

I, Jennifer Li, make this declaration and declare under penalty of perjury as follows:

1. I am employed by Carolina Tobacco Company, the reorganized Debtor in the above captioned bankruptcy proceeding ("CTC") as the Vice President of Legal and Regulatory Affairs. I am responsible for, among other things, interacting with the Settling States regarding statutory compliance matters. I am competent to testify in Oregon courts and make the following statements based on my own personal knowledge and in support of CTC's response to the Settling States' Emergency Motion to Enforce Debtor's Third Amended Plan Dated October

1 18, 2005 (as Modified February 24, 2006) (the "Motion").

2 2. CTC calculates the amount necessary to make its escrow deposits by using  
3 the following formula: *number of cigarettes sold during period x NPM base rate x inflation*  
4 *adjustment rate*. The schedule of NPM base rates is set forth in Exhibit T of the MSA (the  
5 model escrow statute, which all of the relevant states have adopted). The NPM base rate varies  
6 from year to year but is set forth in the model escrow statute.

7 3. However, the inflation adjustment rate is an unknown during the year in  
8 which the sales are generated. Price Waterhouse Coopers ("PWC") is the independent auditor  
9 for the MSA. PWC sets the inflation adjustment in approximately March or early April each  
10 year for the previous sales year. Throughout the sales year, parties can only speculate as to what  
11 the inflation adjustment rate will ultimately be because PWC does not determine the actual  
12 inflation adjustment rate until months after that calendar year is over.

13 4. The product of the NPM base rate and the inflation adjustment rate equals  
14 the accrual rate that CTC uses to calculate the escrow deposits due for a given sales year (the  
15 "NPM Fee Rate"). When the Plan was formulated, including the projections attached to the Plan  
16 as Exhibit 3, CTC had to estimate what the inflation adjustment rate would be to calculate the  
17 NPM Fee Rate for escrow deposits.

18 5. At the time the Plan was formulated and confirmed, the inflation  
19 adjustment rate had not yet been set by PWC for the 2005 sales year. Ultimately, PWC, post-  
20 confirmation, determined that the actual 2005 inflation adjustment rate was 1.2425497. Thus,  
21 the NPM base rate for the 2005 sales year was \$0.0167539 per cigarette. The product of the two  
22 is \$0.02081755 per cigarette. While CTC had estimated that the NPM Fee Rate per cigarette  
23 sold was going to be \$0.0212 for the sales year 2005 the actual rate was \$0.02081755, a lower  
24 NPM Fee Rate per cigarette than CTC had projected in Exhibit 3.

25 6. Historically, CTC has not had to segregate amounts monthly for escrow  
26 deposits to be made in the following year. However, CTC has had to make quarterly escrow

1 deposits to fifteen states that require deposits be made quarterly in a given sales year. With the  
 2 quarterly states, and depending on the state at issue, escrow deposits and certifications are due  
 3 between fifteen days after the end of the quarter to forty-five days after the end of the quarter.  
 4 CTC sends a letter to each quarterly state requesting that that quarterly state provide the total  
 5 number of CTC cigarettes reported as sold during the previous quarter. "Sales" are typically the  
 6 number of cigarettes that have been stamped with the state's tax stamp for sale in that state. This  
 7 information comes from distributor's and stamping agent's reports to the states regarding the  
 8 total number of tax stamps applied to cigarette packs during a quarter. Responses from the  
 9 quarterly states are varied. Some states provide the information, while often times others do not  
 10 have complete information by the time the escrow deposits are due for that quarter. In those  
 11 cases, CTC makes a best determination for that state's quarterly escrow deposit. Once the  
 12 quarterly state has the final figure, it will inform CTC of the total number of cigarettes and  
 13 whether or not CTC over or under deposited for the quarter. Under deposits are made up  
 14 promptly after notification from the state, and over deposits are applied to the next quarterly  
 15 deposit.

16 7. The majority of the fifteen states that require quarterly deposits have  
 17 compliance certification forms that CTC completes whenever a quarterly escrow deposit is due.  
 18 Forms and procedures are not standardized state by state, though some states may use a similar  
 19 form. The compliance form used by some states listed an estimated \$0.02144 rate for 2006 sales  
 20 on their compliance forms as early as April 2006. CTC used this rate to calculate its quarterly  
 21 escrow deposits for all states, except as set forth below in paragraph 8, for the states of California  
 22 (for first quarter) and Washington.

23 8. California's compliance form simply states that the escrow deposit must  
 24 be adjusted for inflation, but does not specifically list a figure to use for inflation. California  
 25 confirmed that it would use the estimated \$0.02144 rate for its quarterly 2006 escrow deposits in  
 26 a letter dated August 24, 2006, in which it requested that CTC deposit an additional



1 approximately \$5,000 for the inflation adjustment for the first quarter. CTC complied with that  
2 request. Washington does not require quarterly escrow deposits to reflect an inflation adjustment  
3 and instead expects that the inflation adjustment be deposited with CTC's escrow deposits in  
4 April of 2007.

5 9. From CTC's experience in dealing with the quarterly states, many  
6 quarterly states seem to view the quarterly escrow deposits as a good faith effort to comply with  
7 the law. Sales figures are often inaccurate or incomplete, on either the state or the  
8 manufacturer's side. Many states realize this and are amenable to the manufacturer making up  
9 the difference after the quarterly deposits have been made or even in the following April 15  
10 deposit.

11 10. Given that CTC has never segregated monthly deposits for the states that  
12 require payment only after the sale year at issue prior to being required to do so during the  
13 bankruptcy, CTC used the NPM base rate for 2005 and 2006 of \$0.0167539 per cigarette and  
14 the NPM Fee Rate of \$0.02081755 (based on the 2005 Inflation Adjustment Rate). In  
15 approximately September 2006, CTC hired Edward Hostman, Inc. to carry out financial  
16 analyses. Based upon EHI's work, CTC adjusted the accrual rate for its monthly deposits into  
17 the segregated accounts to \$0.02144. This rate, which is the rate given to CTC by the quarterly  
18 states as referenced above.

19 I HEREBY DECLARE THAT THE ABOVE STATEMENT IS TRUE TO THE  
20 BEST OF MY KNOWLEDGE AND BELIEF, AND THAT I UNDERSTAND IT IS MADE  
21 FOR USE AS EVIDENCE IN COURT AND IS SUBJECT TO PENALTY OF PERJURY.

22 Dated: January 5, 2007.

23 /s/ Jennifer Li  
24 Jennifer Li  
25  
26

**CERTIFICATE OF SERVICE**

I hereby certify that on January 5, 2007, I served a true copy of the foregoing CAROLINA TOBACCO COMPANY'S RESPONSE TO EMERGENCY MOTION OF SETTLING STATES TO ENFORCE DEBTOR'S THIRD AMENDED PLAN OF REORGANIZATION DATED OCTOBER 18, 2005 (AS MODIFIED FEBRUARY 24, 2006), the DECLARATION OF JENNIFER LI IN SUPPORT OF CAROLINA TOBACCO COMPANY'S RESPONSE TO EMERGENCY MOTION OF SETTLING STATES TO ENFORCE DEBTOR'S THIRD AMENDED PLAN OF REORGANIZATION DATED OCTOBER 18, 2005 (AS MODIFIED FEBRUARY 24, 2006) on the following individuals by electronic notification through ECF or mailing a true copy thereof to the individuals at the addresses listed below by first class mail, deposited with the U.S. Post Office, Portland, Oregon:

Vivienne Popperl  
United States Trustee  
620 SW Main St., Suite 213  
Portland, OR 97205

**Electronic Notification**

Carolina Tobacco Company  
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8 Dated: January 5, 2007.

9 FARLEIGH WITT

10  
11 By: /s/ Tara J. Schleicher  
12 Tara J. Schleicher, OSB #95402  
13 Peter C. McKittrick, OSB #85281  
Of Attorneys for Carolina Tobacco Company